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¶1. (SBU) Summary: The head of the Research Department at the China Securities Regulatory Commission (CSRC) advised a group of analysts from the New York Federal Reserve Bank on April 17 that China's stock market reform process is moving forward, with a new listing process, successful conversion of non-tradable shares and more participation by institutional investors, including by Qualified Foreign Institutional Investors (QFIIs). The QFII program has been especially important in improving governance standards, and the Qualified Domestic Institutional (QDII) program is also poised to begin. The official also sees signs of progress in the development of a corporate bond market. While securities firms are still weak, introducing foreign partners will help bolster their operations. Overall, he believes the markets are much improved and will only become stronger. End summary.

Reforming the Markets

¶2. (SBU) On April 17, a delegation of analysts from the New York FRB met with Qi Bin, the head of the Research Department at CSRC, to discuss recent developments in China's capital markets. Qi began by insisting that the CSRC's priority is further liberalization of the capital markets. In that spirit, the CSRC has recently reformed the listing process. Formerly, listings were determined by the CSRC alone, but now it is more market-driven, with securities firms taking the lead. He confirmed a recent CSRC announcement that listings will resume within a few months. Qi noted that China is both an emerging market and a transitional economy and that its stock markets have a relatively short history. Still suffering from poor governance and disclosure standards, the markets are struggling with many other problems as well, including the non-tradable share (NTS) problem. (Note: Before the NTS reform, two-thirds of the shares of listed companies were state-owned and non-tradable. End note.) He suggested the NTS reform would be finished within a few months. One sign of progress in the reform program is the fact that 25 percent of the market is now in the hands of institutional investors. Although all of the securities firms are essentially bankrupt, the Government is trying to bring in

new incentives like MBOs and stock options. Thus far, 70 percent of the NTS reform has been completed. The goal of the CSRC is to stabilize the market and compensating tradable shareholders is intended to help achieve that goal.

QFII and QDII

¶3. (SBU) Another important contribution to a more stable market, according to Qi, was the introduction of the Qualified Foreign Institutional Investor (QFII) program. Begun in 2002, the program has turned out better than expected by improving the market standard and changing the market philosophy. The QFII program has required companies to improve disclosure and governance. There are currently 39 QFIIs to which US$6 billion of the potential US$10 billion quota has been granted. As for the Qualified Domestic Institutional Investor (QDII) program, Qi stressed that the Chinese Government must be "very careful" to ensure that it leads to an improvement in China's financial system. Noting that a series of new policy announcements had just come out on the QDII program (see ref), Qi said the Social Security Fund and certain insurance companies had already been allowed to begin investing overseas. Retail investors will also be allowed to invest in overseas markets later this year.

Conditions for Bond Market

¶4. (SBU) Commenting on the bond market, Qi said there are a number of government organizations involved in the supervision process, chiefly CSRC, the People's Bank of

China, Ministry of Finance and National Development and Reform Commission. Qi said he sees the explosion in the short-term market as a positive development, but the opening of the bond market has been too slow. Acknowledging there is a lot of pent-up demand by companies to raise money in the bond market, Qi was not sure when longer-term bonds would be allowed. Qi agreed that credible rating agencies are important for the bond market, and noted that Moody's just signed an agreement to enter a joint venture with the Cheng Xin credit rating agency. He also noted that Morningstar has a wholly-owned mutual fund rating agency in Shenzhen. In Qi's view, the prerequisites for a bond market are: quality credit ratings, investor education, good financial institutions and a proper legal environment.

Securities Firm Problems

¶5. (SBU) Regarding securities firms, Qi noted that barring them from operating asset management accounts for clients was an important improvement. Another important step will be making them more competitive by introducing foreign partners. At present, foreign investors are restricted to 49 percent of an asset management company and 33 percent of a securities firm. Qi said progress in reforming the markets and allowing more foreign participation depends on the strength of the market. The stronger the market, the faster reform will move.

¶6. (SBU) Qi said he is most worried about the prospect that the market will remain too small and will crash. He regards the markets as already too far behind China's economic development. Although there has been a lot of negativity about the markets over the past five years, he believes the market is now more disciplined. The worst firms have already been driven out of the market and there is now a possibility of good value investments. Although the market has dropped 50 percent, 120 firms have actually tripled in value. The market was once all speculation but

the situation is now changing.

¶7. (U) This report has been cleared by the New York FRB delegation.

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